Central Coast Council Water's Response to IPART – *Draft Handbook Water Regulatory 3Cs Framework*

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2 Executive Summary

IPART's Draft Handbook provides a good overview of the regulatory framework representative of the final report "Our Water regulatory framework "published in November 2022. The useability of the Handbook would benefit from additional information, explanation, examples, and using plain English to help simplify complex topics (as illustrated in the Australian Energy Regulators Review of incentive schemes for networks' discussion papers December 2022).

Central Coast Council Water's (CCC Water) review was based on:

- how complex concepts are explained ((compared to the Australian Energy Regulator (AER) Handbook))
- the layout and flow of the Handbook
- the completeness of information referencing examples and
- its useability

It does not provide an assessment on the technical aspects of IPART's Water Regulatory framework.

The incentive scheme proposed by IPART will place additional complexity in forecasting both operational and capital expenditure and linking these to the performance defined by the customer outcomes. For smaller utilities, this will require an uplift in planning, process, and technical experience and may limit capacity for the business to move from a "standard" proposal. It is assumed that additional support will be provided to the smaller Water Supply Authorities regarding its practical application where examples are lacking in the Handbook.

The Handbook assumes that a current knowledge of the existing framework is understood. Is it IPART's intention to make changes to the existing "Guidelines for Water Agency Pricing Submission" including changes to the pricing submission checklist or does the Draft Handbook supersede the guidelines?

2.1 General

In general, the Handbook provides the requirements for the new framework and discusses its characteristics. However, it lacks examples of its practical application and at times raises more questions regarding certain aspects of the framework, e.g.:

- Penalties that would be applied from an incorrect assessment by the business. In addition, not achieving performance targets identified in the customer outcomes. How would these penalties be applied in relation to carrying forward the loss over the next determination period?
- Incentive schemes and their practical application in relation to the Outcomes Delivery Incentive Scheme (ODIs). The ODIS is linked to the Capital Efficiency Sharing Scheme (CESS) and the Efficiency Benefits Sharing Scheme (EBSS). It does not discuss how variations to performance

due to uncontrolled events (such as fire, flood, drought, and seasonal impacts impacting water quality (manganese levels) are handled.

- It assumes that expenditure can be accurately forecast over a five-year period. The Handbook does not provide sufficient information relating to how the efficiency gains will be shared between the business and its customers during periods of economic stress. There are illustrative examples in the AER Review of incentives schemes for networks (December 2022) that aid in the application of the incentive scheme; especially the EBSS.
- Not achieving the ODI has ramifications in relation to the default cap of 1% of the revenue requirements for the Capital Efficiency Sharing Scheme (CESS) and the Efficiency Benefits Sharing Scheme (EBSS). More information could be provided regarding how this would be assessed.
- Better clarity is required regarding what a business can exclude for the CESS. Chapter 6 in its discussion regarding incentives states the following:

  "To the extent that a default cap on the size of the revenue adjustment is in place (discussed above), then we would expect that there will be a reduced case for excluding capital expenditure categories. Ultimately, the balance between the various design elements to manage risks is a matter for each business to consider and will be subject to our review and approval. Critical to accepting capital expenditure exclusions is a plan for the water businesses to improve forecasting capabilities for the proposed excluded capital expenditure categories. This reflects the desirability of removing any capital expenditure categories from being excluded in subsequent determination periods".

  The comment implies certain accuracies in the forecasting of capital expenditure exist. This is often not the case especially when priorities for expenditure may change and detailed design highlights additional costs.
- There is discussion around cost consideration in relation to international events and financial markets for long term financial plans. Direction on how this would be done in forecasting costs when the global and local economy can change in short timeframes and where investment plans can go over 10 years. For example, would a strategy be required where inflation, supply chain shocks, bank loans, change of policy, global events and job markets are considered using short to medium economic forecasts?
- Instruction on how to use the Handbook and a brief on the objectives and key points of each chapter would be helpful throughout the document including visualisations on how each of the customer, costs and creditability impact and inform each other.
- As a general observation, not all terms stated in the Handbook are represented in the glossary this includes (but not limited to):
  - Accelerated depreciation
  - Annuities
  - Community
  - Escrow accounts
  - Focus principles
  - Principles
- A quick reference would also enhance the useability of the document in relation to the additional regulatory requirements. A good example of this is represented in the "Better Resets

Handbook, Towards Consumer Centric Network proposals” By the Australian Energy Regulator (AER) (Figure 1 page 7).

3 Detailed summary

3.1 Chapter 1 Introduction

Chapter 1 is an introduction to the regulatory framework and is representative of the overall requirements.

It would be beneficial to include instruction on how to use the Handbook in addition to its purpose and structure defined on page 6. Including a simple visual representation of the new framework including the 12 principals and how they relate and inform each other would add context.

3.2 Chapter 2 Review process and regulatory approach

Chapter 2 defines the review process and timelines including a brief on the assessment process including ex-post expenditure reviews with a focus on systems and processes. It states that businesses will be penalised if their self-assessment grade is higher than that applied by IPART.

More information regarding the key assessment criteria performed by IPART would be beneficial.
It is understood that it will be done against the 12 principles including at least two focus principles. The evidence required and supplied by businesses to support the assessment grade will vary between Water Supply Authorities (larger authorities have greater technical skills and resourcing). For smaller utilities an assurance would need to be made that the assessment criteria and required evidence will be based on an attainable set of requirements related to the size of the business.

On page 32 it states that the business will need to determine at least one focus principle from both the Customer and Cost pillar (based on customer base).

Additional information regarding assessment process is then detailed in section 4.8.2 where it states that the business should focus on the 12 principles with emphasis on the focus principles.
Guidance around IPARTs additional assessment criteria related to the 2 focus principles would be beneficial. The 12 principles are not isolated, they inform and connect with each other as referenced in the CCC Waters diagram in Appendix 1.

3.3 Chapter 3 Engagement and long-term planning

The case studies offered in Chapter 3 provide good background as to the content and delivery expectations of the customer and community in relation to engagement strategies. However, better definition around the differences between community and customer would be beneficial. It is noted that while customer is in the glossary, community is not.

Chapter 3 discusses the three streams that are intertwined i.e.:

- Customer engagement
- Long term planning
- Early engagement with IPART

The chapter also references long term planning and how this must reference the long-term interests of the customers which is representative of customer centricity.

Section 3.2.5 cost considerations, mentions that the long-term strategy should address and provide evidence on matters such as:

- How might key input prices (including labour and materials) change in the future?
- What productivity improvements can be expected to be realised over the multi-decade planning horizon?
- What technological innovations, including those in use at a small scale or on a pilot basis now, can be expected to form part of the service delivery network within the planning horizon?
- What cost shocks might need to be considered over the planning horizon, including from climate change, international events, and financial markets?

It is understood that all these considerations are crucial in developing long term financial plans including those related to costs and reflecting customer preferences. However, guidance in relation to evidence and inputs required would be beneficial, especially related to the international events and financial markets where there is no guarantee of future results. Would there be an expectation that the business includes scenarios and benchmarking which factors in anticipated movements in both international and financial markets as well as alternative future states considering:

1. Climate change
2. Technological opportunities
3. Future population trends and consumer behaviours?

To build these additional scenarios regarding future states into the long-term plans would result in a variety of outcomes. It is noted in chapter 4 section 4.2.1 that "*Any such long-term price paths would need to be accompanied by clear articulation of underpinning assumptions and sensitivities. The business would also need to explain how the long-term price path aligns with its long-term investment plan"* Would there be guidance from IPART relating to how the long-term financial plans and the relationship with the price path remain nimble. Reflecting upon the recent economic conditions where expenditure costs and thus the cost to deliver services is increasing, the additional expenditure is a risk borne by the business.

Currently CCC Water prepare their long-term financial plans based on:

1. Asset plans and strategies
2. Historical expenditure trends
3. Capacity and growth
4. Anticipated large upgrades required

5. Changes to legislation and regulation drivers
6. Climate change
7. Anticipated inflation.

While every endeavour is made to accurately reflect expenditure, it is not until a detailed scope and business case is provided can costs be accurately forecast.

3.4 Chapter 4 Elements of a pricing proposal

Chapter 4 discusses the elements of a pricing proposal including the normal requirements related to the building block model:

- Determination period
- Historical performance
- Forecast expenditure and revenue needs
- Forecast performance
- Price setting

In addition, the pricing proposal is to include:

- Customer, community, and regulatory engagement methods and practices
- Elements and evidence of self-assessment
- Customer and community outcomes linked to expenditure and performance
- Long term price paths to include sensitivities and assumptions
- Inclusion of predictive modelling for capital expenditure
- Incentive mechanisms (ODI, EBSS and CESS) and revenue caps
- Price control
- Accountability and reporting
- Linking forecast expenditure to long term plans
- Forecast expenditure to relate to productivity and efficiency strategies including trends and benchmarking
- Introduction of controlled, uncontrolled, and non-recurring costs with separate forecasts and variations to the base step trend

The way that each of the new elements are applied by both the business and IPART are detailed in other chapters. The Handbook would benefit from placing Chapter 4 earlier in the document and allowing the content to cascade, referencing each new element of the proposal to sections within the Handbook.

3.5 Chapter 5 Addressing the changing revenue needs of water businesses

Chapter 5 discusses the changing revenue needs of the water business and the mechanisms available to manage revenue risk. This is proposed using ways to recovery costs through the price determination, i.e.:

- Cost pass through
- Management within the revenue requirement

- True-ups
- Letters of comfort
- Replacement of the price determination
- Accelerated depreciation
- Annuities
- Escrow account
- Modest change to asset lives

Figure 5.2 on Page 58 provides a good illustration which is simple and easy to understand.

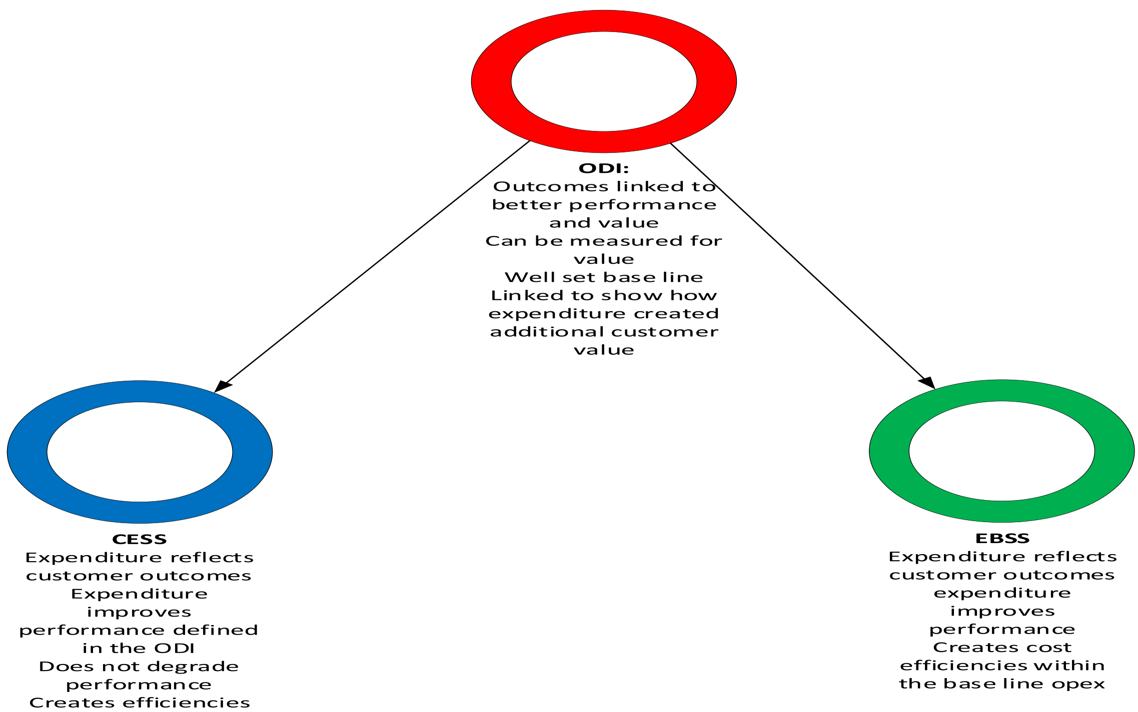
In general, CCC Water has no comment on this chapter.

3.6 Chapter 6 Using financial incentives to drive performance

Chapter 6 discusses the incentive schemes applicable to the 3C's. The new incentive schemes are:

- ODI – Outcome Delivery incentive
- CESS- Capital expenditure sharing scheme
- EBSS – Expenditure benefits scheme

The chapter further discusses the application of these schemes and that all 3 incentive schemes are inclusive. Meaning that, a degradation and no improvement in defined outcomes will not allow the incentive payments related to the CESS or EBSS to be applied.



In a practical sense, allowances would need to be built into the framework in the event of climate impacts on performance outcomes such as flooding, drought, fire and where water quality changes by seasonal influences that are not controllable. How would this be accounted for in the application of the ODI?

In addition, performance can be influenced by location, one what location requires (i.e. water quality) may not be what another location deems relevant. It is understood that within the engagement process, the community needs to define and have input to what is important, and it is the responsibility of the business to balance the outcomes.

It states that IPART expects incentives schemes be applied in the initial determination by businesses that have self-assessed Advanced or Leading (section 4.5). In Chapter 6, it further states that a business deciding not to implement the incentive scheme as part of its proposal would signal a lower confidence in expenditure forecasts (assuming only those businesses with an Advanced or leading assessment). If a business submits a standard assessment and wants to include incentive schemes that there would a requirement to show that the forecast expenditure is robust and efficient.

A business deciding to include incentive schemes must include all three schemes (EBSS, ODI and CESS) as each while operating independently impact each other. The EBSS and CESS scheme are technical in nature in relation to how they are calculated, i.e.:

- Set the base opex or capex allowance in the regulatory review.
- Establish the forecast step change in cost, for relevant years of the determination period, before the costs are incurred
- If the expenditure is triggered, increase the forecast allowance by the forecast efficient costs of the step change
- At the end of the period, calculate the EBSS or CESS payments on the revised allowance (for the period that it applies).

With the new determination period being five years, forecasting expenditure before the costs are triggered could be difficult. The scheme assumes that the base line expenditure is predictable as are the step changes. Does the scheme accommodate the erosion of cost efficiencies during the determination period (due to a changing economic conditions), and what these impacts are in relation to the sharing ratio between the business and the customer?

3.7 Chapter 7 Monitoring ongoing performance

Chapter 7 discusses how IPART will monitor performance and how the business needs to be more accountable to both customers and the community.

CCC Water has no comments regarding this chapter.

4 Appendix 1

IPART 12 principles framework conceptual view – Regulatory reform
Linking Principles to content & outcomes to align to 3c model of customer, cost and creditability

Principle	Link	Content to include	Outcomes
Principle 1 & 5 Customer and community engagement strategy Defines what we engage about, the who and the how Engagement to include other regulators and government bodies	Customer	**Content to include:** Values/outcomes Priorities Performance Communication and engagement Must include a variety of customers groups, comprehensive Defines engagement methods Timings of engagement Cost of service Include environment objectives Choice of services Climate change	**Outcomes** Simple to read and understand Shows how customers can influence services Customers are engaged via variety of channels Clearly defines customers role How it listens to customer views Respond to customer feedback Must promote industry best practice Comprehensive understanding of environmental needs and objectives Must include choice of services
Informs			
Principles 2, 3,4, 5 & 6 Customer and community actual engagement activities Includes regulators and government bodies (separate to community engagement)	Customer	**Content to include:** Collects customer values Collects customer outcomes Determines customer priorities Defines any cost offsets & willingness to pay Long term financial plans Reaches a lot of groups Uses varying engagement methods Must include other regulators related to obligations and climate change	**Outcomes** Shows how customers have influenced priorities, Customers set values and outcomes they are concise, measurable and written from a customer view. Must show value & understand options and price differences Customers are educated and are aware of competing priorities and risks Environmental benefits and how we meet obligations Sets clear accountability standards and reporting methods
Informs			
Principles 7,8,9,10 Pricing proposal Links values and outcomes to OPEX/CAPEX linking to performs measures Includes long term planning	Cost	**Content to include:** Productivity strategies, Trends, Benchmarking & Trade offs Links expenditure to performance Efficient strategy Reflects climate change Reflect long term trends Understand cost implications Link long term strategy to investments Self assessment Pricing strategy Risk management strategy	**Outcomes** Evidence to support proposal values are embedded into proposal Clear explanation of material deviations How improvement to service & performance is linked to expenditure AIR/SIR 10 year investment plans Uses BTS for OPEX Highlights controllable v uncontrollable expenditure as well as cost considerations of climate, international events and financial markets Must include productivity & efficiency strategies, trends and benchmarking
Informs			
Incentives Standard to advanced ODI's CESS EDSS	Cost	**Content to include**: EBSS – Operational incentives/efficiencies ODI's - may require estimation of customer value, linking performance improvements may also include academic studies. Requires fewer than 10 ODI and not overlap. CESS needs to include expenditure items to be excluded also exclusions for forecast costs for uncertain and unforeseen expenditure	**Outcomes** EBSS calculations Clearly shows ODI's and how it reflects values and improvements performance (requires LIS to show progress) Shows new performance measures CESS needs to reflect cost considerations of climate, technology, international impacts AND Financial markets over the forecast period and
defines			
Principles 11 & 12 Delivery Continual improvement	Creditability	**Content to include:** Promises of delivery Progress against investments Managing future challenges and adapt to change when required Manage risk CEO/Councillor signoff Does the proposal define future improvement, lessons learnt	**Outcomes** Clearly show how service outcomes delivered Can show progress to customers Shows monitoring Clear justified self assessment Shows lessons learnt Plans and strategies to address shortcomings

Note: the above follows the same regulatory approach using the Building block model and those standard requirements